2020s – The Decade of Climate Change Investing

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The Covid-19 pandemic has been eye opening for more reasons than one. While this unprecedented black swan event has made us all myopic about our focus on cashflow management and sustainability of our livelihoods, we would be remiss to gloss over the obvious climate change markers that have recently caused devastation worldwide. In case we've forgotten, the severe Australian bushfires, burning of the Amazon rainforest and closer home the increased frequency of floods, cyclones along with the almost biblical locust attacks, have all happened over the last 6 months!

'The sustainability revolution has the magnitude of the agricultural and industrial revolutions but the speed of the digital revolution.' — Al Gore.

Since the adoption of the Paris Agreement in 2015 and its subsequent ratification by most countries, the climate debate has evolved substantially. Majority of climatologists concur that, ceteris paribus, we are currently on course for an increase of 3–4°C global warming above pre-industrial levels, well in excess of the 2°C target of the Paris Agreement and the subsequent 1.5°C target of the IPCC (Intergovernmental Panel on Climate Change)[1].

The significant improvement in air quality with just a few months of Covid-19 related lockdown is a horrific reminder of how much stress we are adding to our carbon sinks on a daily basis. The attempt at limiting greenhouse gas emissions to prescribed levels will require a dramatic rebalancing of entire energy, transportation, food and agriculture value chains. The effect of attempting such a feat will not be limited to high-impact sectors such as coal, oil and gas, mining, utilities and manufacturing; instead the competitive dynamics of almost every industry and business will be affected. The scope and scale of our next steps are required to be truly transformational.

2020 will prove to be a critical year for climate action as nations, governments and businesses now move away from long drawn climate mitigation and instead have recognized the urgent need for 'here and now' climate resilience and adaptation techniques. Regulatory targeting and public investment are imperative owing to the scale of the problem and how well entrenched it is in our economy; the complexity of the requisite solutions will however require massive amounts of focused private capital.

For many years, conventional wisdom in the investment industry was dominated by the mistaken belief that ESG (Environment, Social and Governance) friendly investing is detrimental to the investors' / managers' fiduciary responsibilities and investing with ESG considerations in mind would be compromise to a firm's financial performance. This turned into a self-fulfilling prophecy because focus on ESG considerations were not priced into business valuations and were instead considered 'good to have' expenses compromising financial returns.

Recently however this ideology has been overturned by the overwhelming empirical evidence in the favor of economic value driven by upsides of an ESG forward investment through revenue (enabled by strong macroeconomic tailwinds), cost savings (enabled by efficiency resource use and process control), risk mitigation (enabled by protection against physical, regulatory, competitive and reputational risk factors that may be associated with the likes of climate change) and higher multiples at exit. It is now accepted that the failure to address ESG considerations is actually a gross negligence of fiduciary responsibility. This new interpretation is beginning to be enshrined in legislation, regulation and industry wide investment practice.

ESG-focused funds have performed at-least comparable to their non-ESG focused peers between 2014 and 2018[2] and are contributing to strong financials returns as evidenced by data on majority sustainable funds consistently ranking in the top half of their respective categories[3]. This is compelling evidence that a robust ESG investment can improve long-term risk-adjusted returns.

A large data point that cannot be ignored is a shift in investor profiles towards millennials who are poised to inherit USD 30 trillion of inheritable wealth in coming decades of which 70-80% are likely to reconsider their investment goals[4] in favor of the emerging themes of impact investing; of these themes, climate change investing has emerged on top in 2019 up from number 5 in 2018[5]. Millennials are changing the future of investments with a significant majority of them claiming to make investments which have positive effect on environment[6]. With what seems to be the 'the Greta Thunberg effect' it is to be noted that these millennials are not only the investors in the near future but also the target consumers for our businesses.

In recent years we've seen the emergence of many businesses and investment opportunities that are ESG focused or are actively working towards transitioning to a low carbon economy, there has been a growing traction seen by green bonds and green-project finance (initially supported by development / public capital), the entry of institutional VC / PE capital in the space with impact-focused 'mega-funds' emerging in past 5 years and their focus on investment strategy linked to detailed social and environmental KPIs congruent with financial return objectives.

Granted the nascent stage of such institutional capital in ESG investing, the verdict on whether they are set to generate high returns for investors, is inconclusive yet. However, a relatively meritorious indicator of their success is the ability of individual ESG funds to raise a second round of capital for these ESG related target areas like - TPG's Rise Fund II (target USD 2.5 bn with USD 1.7+ bn secured by 2019), Bain Capital Double Impact Fund (on target to raise USD 600 mn), and other managers diversifying to this asset class like KKR's Global Impact Fund (USD 1.3 bn), Apollo Global Management and Blackstone. Closer home, Eversource Capital's Green Growth Equity Fund is India's largest climate focused fund.

Climate change may turn out to be the most critical, high-impact, and multifaceted of the host of ESG challenges we face today. As the effect of this global phenomenon becomes more prominent, high ESG standards shall be an even more critical driver for companies' ability to compete and demonstrate preferred financial performance for investors and shareholder in the future. It is imperative to note that the adverse environmental, economic and social impacts of climate change are highly likely to impact the most vulnerable segments of the population disproportionately. Therefore, the importance of an imminent transition to a climate friendly economy is receiving greater visibility in the global climate change dialogue. Investing in companies today that have a first mover advantage in addressing climate risks and driving value from its opportunities, should position portfolios well for a future in which this critical theme assumes ever-increasing importance.

As per the Global Climate Risk Index 2020, India is the fifth most vulnerable country to climate change, exacerbated by low per capita income, social inequality and a heavy reliance on agriculture. Recognizing this urgency for climate action - since ratifying the Paris Agreement and declaring its Nationally Determined Contributions, the Government of India has taken affirmative steps to crowd in public and private capital for climate investments and mitigate the impact of climate change. The ambitious target of 450 GWs of renewable energy capacity installed by 2030, strong regulatory and funding support for e-mobility through the FAME (Faster Adoption and Manufacture of EVs) Scheme, waste processing and segregation at source being made mandatory as per Solid Waste Management Rules 2016 and formation of a separate 'Jal Shakti' Ministry to address India's water management challenges are examples of the government's commitment to holistically combat climate change.

Finally, the most compelling reason driving climate change investing is the declining Total Cost of Ownership (TCO). Renewable energy, especially solar, already has the lowest incremental cost as compared to any other form of energy (especially from fossil fuels). Plunging battery costs is leading to electric vehicles fast becoming competitive against combustion engine vehicles and even lower in many use cases. These cost advantages are being driven by scaled manufacturing sources, global supply chains, continually improving efficiencies in technologies and zero cost of the resource.

There is an opportunity to invest nearly USD 3+ trillion in Climate Smart Investments in India across renewable energy, waste management, energy efficiency, transportation, water and agriculture[7]. Driven by a strong demand for climate action, flexibility to develop business models customized for the Indian market calibrated by experience from developed countries, openness to innovation and technology, and a strong regulatory mandate – the next decade is set to be the decade for climate investments.

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2 https://www.morganstanley.com/content/dam/msdotcom/ideas/sustainable-investing-offers-financial-performance-lowered-risk/Sustainable_Reality_Analyzing_Risk_and_Returns_of_Sustainable_Funds.pdf

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4 https://www.ey.com/Publication/vwLUAssets/ey-sustainable-investing-the-millennial-investor-gl/$FILE/ey-sustainable-investing-the-millennial-investor.pdf

5 https://www.cnbc.com/2019/12/31/climate-change-investing-catches-on-with-millennials.html

6 https://www.forbes.com/sites/forbesfinancecouncil/2019/04/02/how-millennials-are-changing-the-future-of-investment/#317cb7c42feb

7 https://www.ifc.org/wps/wcm/connect/fa3bea68-20f1-4cb4-90b9-3e812d38067f/Climate+Investment+Opportunities+in+South+Asia+-+An+IFC+Analysis.pdf?MOD=AJPERES&CVID=l.raVua